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### Understanding the CEO Pay Debate: A Primer on America's Ongoing C-Suite Conversation

White Paper by  
Susan Holmberg and Michael Umbrecht  
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### EXECUTIVE SUMMARY

The problem of rising CEO pay is an extraordinarily complex and contested issue. This primer on CEO pay serves to unpack this complicated topic by a) explaining the problems with CEO pay, including the harm it imposes on workers, businesses, and society; b) highlighting some of the early history of CEO pay, including a handful of the key policies that have shaped it; c) presenting the main theories that attempt to explain why CEO pay has risen so dramatically; d) addressing the fallacy of shareholder primacy and introduces the stakeholder model; and e) concludes by highlighting some policy recommendations that are outside of the shareholder primacy framework.

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## Understanding the CEO Pay Debate: A Primer on America's Ongoing C-Suite Conversation By Susan Holmberg and Michael Umbrecht, October 23, 2014

### INTRODUCTION

Skyrocketing CEO compensation has long been a source of frustration for many Americans, and a heightened concern after the Occupy movement injected economic inequality back into the national debate and the American consciousness. Just about every spring – during proxy season – we read the latest corner office profiles of CEOs enjoying lush company perks and see the current rankings of the highest paid CEOs, images which grossly juxtapose with the stagnating wages of the typical worker and the economic burdens so many of us face, particularly since the 2008 global economic crisis.

Rarely, however, does the press coverage go beyond the problematic moral symbolism of a new Gilded Age. What typically is not conveyed in many of these press articles on CEO pay is that the enormity of CEO pay packages – and the way CEOs are paid – can have devastating effects on our economy. Indeed, many economists argue the enormous sums of stock-heavy compensation fueled reckless CEO behavior that contributed to the financial crash of 2008. A handful of high profile economists – Thomas Piketty, Joseph Stiglitz, and Robert Reich, to name a few – are starting to trumpet that a high degree of economic inequality precipitates financial instability because it leads to a decline in consumer demand, which has tremendous spillover effects in terms of investment, job creation, tax revenue, and more.

Rising CEO pay is a hugely contested issue in the U.S., and has been since the early twentieth century, particularly during economic downturns and concurrent rising inequality.<sup>1</sup> Yet most of the current debate focuses on the rapid rise in CEO pay over the past three decades, presumably because the recent numbers are so startling. Between 1940 and 1970, average executive pay remained below \$1 million (in 2000 dollars).<sup>2</sup> From 1978 to 2013, executive compensation at American firms rose 937 percent, compared with a sluggish 10.2 percent growth in worker compensation over the same period.<sup>3</sup> In 2013, the average CEO pay package at S&P 500 Index companies was worth \$11.7 million.<sup>4</sup> CEO pay topped out with Oracle's \$78.4 million pay package for Larry Ellison, who frequents these rankings and was the first to accumulate more than \$1.8 billion in pay over the past 20 years.<sup>5</sup>

Because of Occupy Wall Street and more recently the attention on Thomas Piketty's bestseller, *Capital in the 21<sup>st</sup> Century*, progressives are increasingly focused on America's rising economic inequality. Yet while progressives recognize high CEO pay as a potent symbol of the enormous concentration of wealth in this country at the expense of working people, what is less understood is that the dramatic escalation of CEO pay actually contributes to economic stagnation.

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<sup>1</sup> According to a Huffington Post poll, two-thirds of Americans think CEOs and top corporate executives are paid too much. Swanson, Emily. 2014. "Most Americans Think Executives' Pay is Too High, Poll Shows." *Huffington Post*, February 13. Retrieved August 5, 2014 ([www.huffingtonpost.com/2014/02/13/executive-pay-poll\\_n\\_4780170.html](http://www.huffingtonpost.com/2014/02/13/executive-pay-poll_n_4780170.html)).

<sup>2</sup> Frydman, Carola and Raven E. Saks. 2010. "Executive Compensation: A New View from a Long-Term Perspective, 1936-2005." *The Review of Financial Studies* 23(5):2099-2138.

<sup>3</sup> Mishel, Larry and Alyssa Davis. 2014. *CEO Pay Continues to Rise as Typical Workers are Paid Less*. Economic Washington, DC: Policy Institute. Retrieved July 29, 2014 (<http://www.epi.org/publication/ceo-pay-continues-to-rise/>).

<sup>4</sup> AFL-CIO Executive Paywatch, found at AFL-CIO. 2014. "Executive Paywatch: High-Paid CEOs and the Low-Wage Economy." Retrieved May 28, 2014 (<http://www.aflcio.org/Corporate-Watch/CEO-Pay-and-You/>).

<sup>5</sup> Dant, Alastair and Karl Russell. 2014. "The Pay at the Top." Retrieved July 29, 2014 ([http://www.nytimes.com/interactive/2014/04/13/business/the-pay-at-the-top.html?\\_r=0](http://www.nytimes.com/interactive/2014/04/13/business/the-pay-at-the-top.html?_r=0)).

In fact, there is a growing body of evidence that sky-high CEO pay is not just a moral issue: it is a drag on the economy. However, for those interested in the issue but new to it, the causes can be mystifying. Researchers from several academic fields have written an almost impenetrable body of academic literature on executive pay that covers a vast range of topics. In an attempt to understand why the numbers continue to escalate, there exist a handful of competing theories, including some that claim high CEO pay is entirely justified and not problematic for society. The ways in which executives are paid (salary, bonuses, stock options, etc.) varies among executives and has changed significantly over time, which complicates, among other things, how pay is measured and our understanding of its economic effects. Finally, the role of shareholders, who do not fit into the one-size fits all model, adds another layer of confusion into the question about what CEOs are being paid to do (i.e. maximize profit for shareholders or build the long-term health of the company).

Despite its complexity, the problem of rising CEO pay will not be solved unless it is first adequately understood. This report strives to serve as a guide on the CEO pay debate to demystify a confusing topic while also highlighting some key policy ideas.

This guide is structured as five sections. The first section explains the problems with CEO pay, including the harm it imposes on workers, businesses, and society. The second section introduces some of the early history of CEO pay, including a handful of the key policies that have shaped it. The third section presents the main theories that attempt to explain why CEO pay has risen so dramatically. The fourth section addresses the fallacy of shareholder primacy and introduces the stakeholder model. Finally, we conclude by highlighting some policy recommendations that are outside of the usual CEO pay debate.

We also include two appendices for more extensive background. The first appendix presents the different types of compensation found in executive pay packages – stock options, stock grants, and so forth – as well as the different pay metrics used in a handful of widely circulated reports.<sup>6</sup> To augment our discussion of CEO pay reform policies, Appendix 2 presents a comprehensive (and more technical) timeline of CEO pay policies, from the 1933 Pecora hearings to the Dodd-Frank Wall Street Reform and Protection Act of 2010.

While this report is not exhaustive, it is designed to orient the reader to an important debate that is getting increasingly more attention, particularly in the context of America’s rising economic inequality. We hope that you find it useful and that it enhances your understanding of why CEO pay is such an important economic issue.

## THE PROBLEMS WITH CEO PAY

There are two broad reasons CEO pay should be a concern to anyone who cares about economic prosperity in the United States. The first reason relates to how CEO pay is structured, in other words, the particular pay package executives are offered. For example, are they paid strictly in salaries (likely not)? Bonuses? Stock grants? Stock options? We explain all of the components of CEO pay in Appendix 1, but the basic point is that what companies pay their executives with has far-reaching consequences for our economy in terms of CEOs taking on too much risk, committing fraud, reducing productive investments in research and their workforce, and in terms of their tax bill. The second reason relates to how much CEOs are paid. Whether the level of pay is an issue or not is extremely controversial among economists, particularly as it relates to the typical worker, whose wages have been stagnating for decades despite rising labor productivity. We talk about the broad problems of inequality, which CEOs play a material role in, and touch on the debate as to whether workers’ stagnating wages and what CEOs are paid are connected. This debate heavily draws on economic theories about how wages are determined and we will pick it up in more depth in the section on economic theories of CEO pay.

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<sup>6</sup> This is based on an Economic Policy Institute paper on CEO pay methodology. Mishel, Lawrence and Natalie Sabadish. 2013. “Methodology for Measuring CEO Compensation and the Ratio of CEO-to-Worker Compensation, 2012 Data Update.” EPI Working Paper #298. Economic Policy Institute, Washington, DC. Retrieved July 29, 2014 (<http://www.epi.org/files/2013/wp298-ceo-to-worker-pay-methodology.pdf>).

### ***Problems with CEO Pay Structure***

The main reason the structure of CEO pay can be so problematic is its effect on the way CEOs make decisions on the job. In economist speak, it distorts their incentives, tempting executives to take on too much risk, which they don't bear much of, and even to behave fraudulently, and lessens their motivation for investing in the business. All this, and their paychecks cost taxpayers billions of dollars.

#### *Risk*

Certainly one of the fundamental makings of a successful business leader and entrepreneur is willingness to take big risks. Starting a business, moving into new markets, developing new products, and so forth all come with great risks – of losing profits, shutting down departments, even closing a company's doors. One of the main arguments for high CEO pay is that it compensates executives for being exceptionally calculating risk-takers. Yet there is also evidence that when CEOs are paid with stock, it can enable them to become very wealthy very quickly without bearing much of the risk. This creates the financial motivation for shortsighted and extremely high-risk decisions in order to boost their company's stock prices, which will ultimately line their own pockets. The effects of this behavior, particularly with CEOs in the financial industry, are that it creates higher share price volatility (meaning large swings in share prices) and it increases the chance of bank failures, a risk to the broader financial system that we are all too familiar with, and the burden placed on taxpayers to bail out, for example, the "Too Big to Fail" Banks.<sup>7</sup>

#### *Fraud*

What is additionally troubling about the ways in which CEOs are paid is that incentives can easily move from risky behavior towards fraudulent behavior, including misrepresenting the company's finances and illegal stock options backdating.<sup>8</sup> Studies demonstrate that firms found to be fraudulent have greater stock option-based compensation, suggesting that the greater the incentive for CEOs to maximize the company's stock price, the greater the incentive the CEO has to engage in fraudulent activities to accomplish this objective.<sup>9</sup>

#### *Decline of Long-Term Company Health*

CEO pay that is ultimately based on a company's share price invites ways to show "performance" that ultimately discourages new hiring, wage increases, and investment in research and innovation. According to economist William Lazonick, companies have increasingly spent more of their profits on stock buybacks to boost the value of stock, which has been "diluted" by the heavy use of stock-based compensation.<sup>10</sup> In other words, when stock options and stock grants are issued, a company's outstanding shares rise and share prices fall – that is what we mean by dilution. Buybacks, also called share repurchases, have a countervailing effect; they shrink the supply of a company's shares in the market and that results in higher share prices. What does this have to do with CEO

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<sup>7</sup> See, for example, Squam Lake Working Group on Financial Regulation. 2010. "Regulation of Executive Compensation in Financial Services." Squam Lake Working Group Working Paper 8. Council on Foreign Relations, New York. Retrieved July 29, 2014 (<http://www.cfr.org/financial-crises/regulation-executive-compensation-financial-services/p21497>).

<sup>8</sup> Backdating of stock options became a scandal in the late 2000s. By retroactively changing the date when a stock option was granted, typically to an earlier date when the share price was lower, companies can change the baseline by which performance was measured, making it look better than it was, in order to pump up executive pay. At its peak, this was not a rare practice: according to a study led by Lucien Bebchuk of Harvard, between the mid-1990s and mid-2000s, 12 percent of firms backdated options for their CEO, boosting total compensation by around 20 percent. Bebchuk, Lucien, Yaniv Grinstein, and Urs Peyer. 2009. "Lucky CEOs and Lucky Directors." *Journal of Finance* 65(6):2363-2401. Retrieved July 29, 2014 ([http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1405316](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1405316)).

<sup>9</sup> See, for example, Denis, David J., Paul Hanouna, and Atulya Sarin. 2006. "Is There a Dark Side to Incentive Compensation?" *Journal of Corporate Finance* 12(3):467-488.

<sup>10</sup> See Lazonick, William. 2014. "Taking Stock: Why Executive Pay Results in an Unstable and Inequitable Economy." Roosevelt Institute White Paper. Roosevelt Institute, New York. Retrieved July 29, 2014 ([http://rooseveltinstitute.org/sites/all/files/Lazonick\\_Executive\\_Pay\\_White\\_Paper\\_Roosevelt\\_Institute.pdf](http://rooseveltinstitute.org/sites/all/files/Lazonick_Executive_Pay_White_Paper_Roosevelt_Institute.pdf)).

pay? There is research that shows that one of the main reasons companies conduct stock buybacks is to offset their executive compensation packages, which typically consist mainly of stock options and stock grants.<sup>11</sup>

The practice is not objectionable merely because of the high level of CEO pay made possible through what is essentially stock manipulation; another important issue is that it represents one part of a zero-sum game. In other words, this is a pot of money that would find a better use if reinvested in the company; research, development, employee hiring and training, higher wages, retention programs, and many other areas associated with long-term financial and organizational health are sacrificed because of the sheer scale of corporate buybacks. Stock buybacks allow companies to inflate the level of CEO compensation, while restricting funding for innovative and prudent projects that could lead to higher profits, higher wages, and better working conditions for the average employee. See the box on Hewlett-Packard for a useful example from Lazonick.<sup>12</sup>

**Hewlett-Packard's** corporate behavior since the millennium serves as a perfect example of the negative effects of both overvaluing executive contributions to a company and overemphasizing share price as an organizational goal. The longstanding icon of American innovation and dedication to employees spun off its engineering division in 1999 in order to focus on high-margin software, taking with it the company's former commitment to employees in favor of a low-cost, "employee churn" approach that offered little employment security. This transition to higher-margin activities was not, however, reflective of a dedication to software development, but rather to an ideology that focuses solely on shareholder value; the company began to engage in large scale buybacks totaling \$61.4 billion from 2004 to 2011, 120 percent of their net income in that period. As a result, the required investment in innovation and productivity never materialized, likely contributing to the company's \$12.7 billion loss in 2012. The company responded to this crisis in 2013, not by ousting the executive team—including CEO Meg Whitman who accepted the position in 2011 and was named the "Most Underachieving CEO" by *Bloomberg* in May of 2013—but by slashing employment by another 17,800 jobs with 32,500 additional layoffs planned for this year. Throughout HP's transition from the standard bearer of innovation and employee commitment to a profit-obsessed and short-term oriented corporate entity, HP CEOs received a combined \$210 million while other top executives at the firm averaged \$101 million over the period, with between 37 and 47 percent of that compensation from stock and options rewards inflated by the buyback programs that have dominated the corporate strategy over the last 10 years.

### *The Tax Bill*

Beyond the evidence that suggests the structure of CEO pay can expose shareholders and the financial system at large to excessive risk, incentivize fraud, and divert corporate resources from long-term investment toward stock price manipulation in the form of buybacks, there is also the issue of the tax treatment of performance pay. A study by the Economic Policy Institute calculates the loss in tax revenues from executive compensation tax deductions in 2007 to be between \$6 and \$13.7 billion.<sup>13</sup> In 2009, this loss ranged from \$3.5 to \$8.3 billion and the total amount lost between 2007 and 2010 was \$30.4 billion. This is, of course, not calculating any secret backdating of stock options.

### *The Relative Value of CEO Pay*

Many economists agree that the structure of CEO pay, i.e. the ways in which they are paid, affects their behavior in the ways we just described. But not as many agree that the amount they are taking home, particularly

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<sup>11</sup> For example, in addition to Lazonick's research, Klassen and Sivakumar's (2001) research looks at repurchase and option activity for nonfinancial firms from 1995 to 1999. Their findings indicate that firms repurchase shares particularly to avoid dilution from stock option compensation programs. Griffin and Zhu's research (2009) also find a positive and contemporaneous (i.e., not sequenced) relationship between CEO stock options and share repurchases, suggesting that the buybacks are meant to counter the dilutive effects of the exercise of stock options.

<sup>12</sup> Lazonick, William (2014).

<sup>13</sup> Balsam, Steven. 2012. "Taxes and Executive Compensation." Economic Policy Institute Briefing Paper #344. Economic Policy Institute, Washington, DC. Retrieved July 29, 2014 (<http://www.epi.org/publication/taxes-executive-compensation/>).

compared to the typical worker whose wages have stagnated for decades despite consistently rising labor productivity, is a problem of much concern. The way we address this argument here is to highlight that high CEO pay is a key contributing factor to America's rising economic inequality problem. We also challenge a common argument that CEO pay and workers wages are not related to each other, that what a worker earns has nothing to do with the size of a CEO pay package.

By now, thanks to economists like Joseph Stiglitz and Robert Reich, the story of America's growing inequality might be familiar to you. After several decades of growth and stability for America's middle class, economic inequality began increasing sharply in the 1970s. Often called the "Great Prosperity," the period after World War II to the late 1970s saw robust economic growth with strong public investment and rising wages – earnings at least partially due to strong union membership – and diminished inequality.

Starting in the late 1970s, however, several factors led to a growing concentration of wealth and stagnant wages for most American workers. Corporations facing international competition moved manufacturing jobs overseas. The bargaining power of unions was weakened by corporate resistance to unionization backed by weak government enforcement of labor laws. The financial industry pushed for deregulation, leading to extremely risky behavior, including encouraging consumers to take on rising debts to compensate for shrinking earnings.

The U.S. now has the highest income inequality of any developed country, which, in addition to being considered unjust, is an enormous problem for our economy. According to the Secretary-General of the OECD, Angel Gurría, for every 1 percent that inequality grows, there will be a drop in growth of approximately 0.2 to 0.3 percent. In other words, "a more unequal society will grow less, and inequality becomes an obstacle to growth in and of itself."<sup>14</sup> The reason that economic inequality is bad for growth is that the more wealth that is concentrated in the hands of a few, the less goods and services are purchased by the public (what economists call aggregate demand), which decreases the amount of jobs, which again decreases aggregate demand, and so on.

Perhaps the most well known data sets in the inequality debate come from newly anointed celebrity economist Thomas Piketty and his colleague Emmanuel Saez's are perhaps the most familiar to audiences interested in the inequality debate. It was Piketty and Saez who inspired and validated Occupy Wall Street's lament about the top 1 percent wealthiest people. Using historical tax data for the first time,<sup>15</sup> Piketty and Saez went deeper into the inequality question by identifying which specific groups were winning and losing over the past three decades. They asked, for example, whether the growth in income was also being enjoyed by the upper middle class or only captured by the very top tier.

Piketty and Saez found that the earnings of the very richest segments of society have increased with an accelerated speed, whereas the share of other high-income groups declined, as well as that of poorer groups, of course. The share of total annual income received by the richest 1 percent has more than doubled from 9 percent in 1976 to 20 percent in 2011. According to Piketty and Saez and their colleagues, "There have been rises for other top shares, but these have been much smaller: during the same period, the share of the group from 95<sup>th</sup> to 99<sup>th</sup> percentile rose only by 3 percentage points." Their numbers also show that as the highest earners in the United States comprise an increasingly larger share of overall income, we have almost as much inequality now as just before the Great Depression (see Chart 1 below).<sup>16</sup>

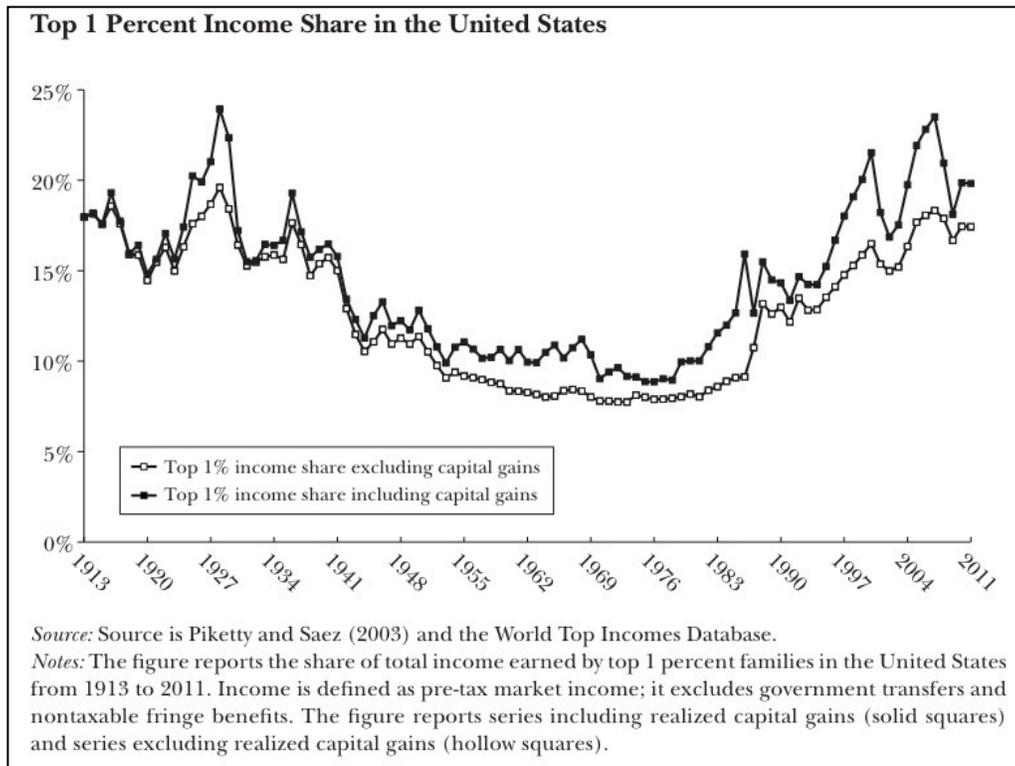
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<sup>14</sup> PBS Newshour. 2014. "How to Combat the Tightening Grip of Inequality around the Globe." June 12. Retrieved July 29, 2014 (<http://www.pbs.org/newshour/bb/combat-tightening-grip-inequality-around-globe/>).

<sup>15</sup> While existing data only went back four decades, Piketty and Saez conducted research at the Internal Revenue Service, building a dataset that reached back to 1913.

<sup>16</sup> Alvaredo, Facundo, Anthony B. Atkinson, Thomas Piketty, and Emmanuel Saez. 2013. "The Top 1 Percent in International and Historical Perspective." *Journal of Economic Perspectives* 27(3):3-20.

Chart 1



What do these numbers have to do with CEO pay? The growth of executive pay in particular has fueled income inequality trends in the U.S. According to the Economic Policy Institute, “Executives, and workers in finance, accounted for 58 percent of the expansion of income for the top 1 percent and 67 percent of the increase in income for the top 0.1 percent from 1979 to 2005.”<sup>17</sup> Another calculation by economists Ian Dew-Becker and Robert Gordon makes a similar argument. They found that the large increase in share of the 99.99th percentile is mostly explained by the incomes of superstars and CEOs.<sup>18</sup>

To summarize, we know that economic inequality is rising at an alarming rate in the U.S. Inequality is not only what many consider to be a moral problem, it is bad for our economic progress. We also know that skyrocketing CEO pay is a key driver of our rising inequality. These facts should be enough to demonstrate that executive pay levels, and not just the structure of pay packages, are a public policy problem that needs addressing. But there is, in fact, another issue that drives the CEO Pay argument home: what CEOs make relative to the workers in their firm.

A common argument in the CEO pay debate is that the amount a CEO takes home in pay has no bearing on a workers wages. The two processes of wage determination at a firm are completely separate. William Lazonick’s

<sup>17</sup> Mishel, Lawrence and Natalie Sabadish. 2012. *CEO Pay and the Top 1%: How Executive Compensation and Financial-Sector Pay Have Fueled Income Inequality*. Washington, DC: Economic Policy Institute. Retrieved July 29, 2014 (<http://www.epi.org/publication/ib331-ceo-pay-top-1-percent/>).

<sup>18</sup> Dew-Becker, Ian and Robert J. Gordon. 2005. “Where Did the Productivity Growth Go? Inflation Dynamics and the Distribution of Income.” NBER Working Paper No. 11842. National Bureau of Economic Research, Washington, DC. Retrieved July 29, 2014 (<http://www.nber.org/papers/w11842.pdf>).

research pushes back on that argument by identifying a direct linkage between CEO pay and workers wages through the practice of stock buybacks. Recall that stock buybacks are a means of stock manipulation, which are used to offset the effects of giving so much stock-based pay to executives. The financial resources that are used for buybacks could be – and were in the past – used on items that build the long-term health of the business, including raises for workers.

A rebuttal to Lazonick’s line of reasoning is that the free cash flow, if not used for buybacks, would not automatically go to workers. Indeed, without strong bargaining power of workers, based on well-enforced national labor laws, workers aren’t necessarily going to see their wages increase with their productivity. It’s not coincidental that CEO pay was at its lowest and median wage growth at its strongest – between the 1940s and 70s – when this country’s labor force had strong union representation. However, since 1973 wage growth has fallen far short of increases in productivity. In other words, in any discussion about CEO pay reform, strengthening our labor laws and expanding their scope to address the structure of today’s economy, so that workers are able to claim a larger share of the wealth they produce, must be made a priority.

## LOOKING BACK ON THE CEO PAY DEBATE

Much of the current CEO pay argument is so focused on current numbers that it’s easy to forget that executive pay has been a recurring topic of debate since the early twentieth century. Yet this history is extraordinarily important for informing the ideas for change that we develop in the present. This section provides a brief sketch of that history, including the birth of the corporate CEO and performance pay, more about how the numbers have changed over the decades, and some of the key policy reforms policies that have been attempted.

The history of CEO pay policy itself is a confusing labyrinth of major and minor adjustments that target either the level or structure of pay, or both. Rather than going into too much depth about policy in this section, Appendix 2 presents a comprehensive (and slightly more technical) timeline of CEO pay policies all the way back to the 1933 Pecora hearings.<sup>19</sup>

It’s strange to imagine, but the position of corporate CEO is a relatively new one in the history of American business. According to Harvard Wells, who has written one of the most comprehensive reviews of CEO pay history, before the “great merger movement” of the early twentieth century, most companies were much smaller and run by managers who owned a sizeable portion of the business, which meant that they didn’t receive salaries but reaped financial rewards from owning capital in the company.<sup>20</sup> At the beginning of the twentieth century, the face of industry was morphing from thousands of small manufacturing firms into fewer large corporations. As owners of these companies opted out, executives – the majority paid only with salaries – gradually took over those management roles.

Believing that an executive salary would never imbue managers with the same stake in a company that owners inherently have, Wells explains, American Tobacco and U.S. Steel were among the first, in the 1910s, to institute bonus systems for senior executives, which paid a percentage of annual profits in addition to their base salary. By 1928, a survey of 100 industrial companies showed that 64 percent of paid executives received a bonus, typically in the form of cash linked to the firm’s annual profits. The same survey also found that for executives paid with bonuses, this new form of “performance pay” constituted 42 percent of the average executive salary.

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<sup>19</sup> The timeline is primarily based on respective articles by law professor Harwell Wells and economist Kevin Murphy as well as Sam Pizzigati’s book *The Rich Don’t Always Win: The Forgotten Triumph over Plutocracy that Created the American Middle Class, 1900-1970*.

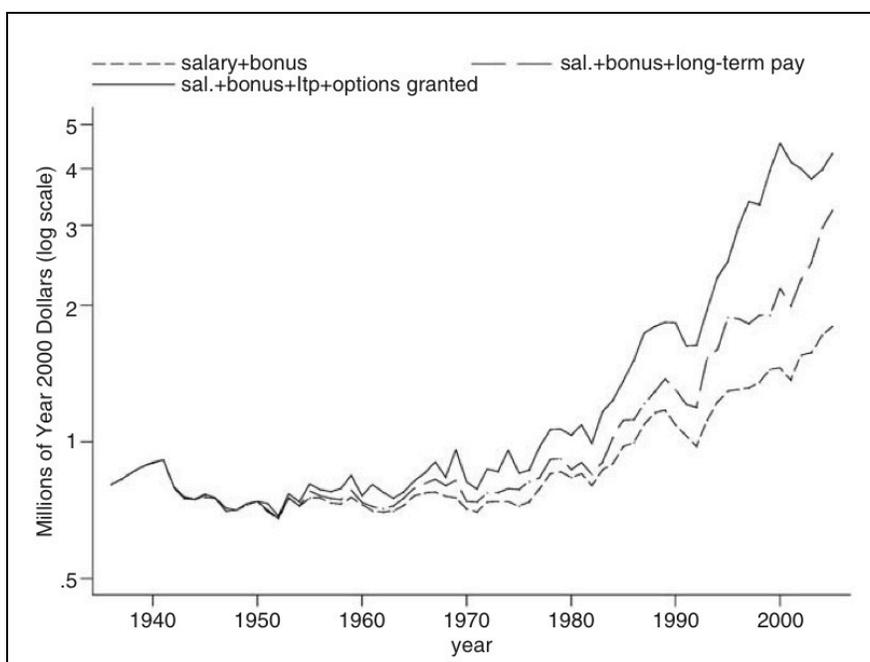
<sup>20</sup> Wells, Harwell. U.S. Executive Compensation in Historical Perspective. Research Handbook on Executive Pay. Editor Randall S. Thomas and Jennifer G. Hill. Edward Elgar. Northampton, MA, USA. 2012.

We have little data about CEO pay levels prior to 1934 when the Securities Exchange Act mandated disclosure of senior officers' pay. However, an earlier survey tells that before World War I the average executive salary was \$9,958, which is \$220,000 in 2010 dollars. For the industrial firms in that 1928 survey, the median annual compensation was \$69,728, or \$892,000 in 2010 dollars - an increase of over 300% from the pre-World War I numbers.<sup>21</sup>

Starting in 1930, a handful of shareholder lawsuits put the issue of executive pay on the front page, culminating in Congress's "Pecora hearings" on the securities industry. The hearings revealed that Charles Mitchell, of National City Bank (now Citibank), who was blamed for fueling the speculation that led to the Crash of 1929, took home more than \$1 million annually in the years leading up to the Crash, a revelation which of course inflamed shareholders and the American public and prompted the Federal government to institute the first of many reforms over the decades, starting with the Securities Act of 1933 and the Securities Exchange Act of 1934.

The most comprehensive historical empirical analyses of CEO pay, by Carola Frydman and Raven Saks, indicates that average pay remained below \$1 million (in 2000 dollars) from 1936 to the mid-1970s (see Chart 2 below), despite the fact that there was a lot of company growth during that time span. It even fell in the 1940s (sharply during World War II and more gradually in the late 40s, which, according to the authors was the last noticeable decrease in the past seven decades.

**Chart 2: Median Total Compensation and Its Components**



Source: Frydman, Carola and Raven E. Saks. 2010. "Executive Compensation: A New View from a Long-Term Perspective, 1936-2005." *The Review of Financial Studies* 23(5):2099-2138.

<sup>21</sup> This survey information is in Wells (2012).

From the early 1950s to the mid-1970s, the inflation-adjusted value of executive pay increased very gradually, averaging less than 1 percent growth a year.<sup>22</sup> Growth in pay picked up speed starting in the mid-1970s and continued until the recent financial crisis, with the most significant increase in the 1990s, when annual growth rates topped over 10 percent. As we described in the introduction, between 1978 and 2013, according to the Economic Policy Institute, executive pay rose 937 percent.

This enormous rise in CEO pay came despite the fact that there have been an extraordinary number of policies, administered by a variety of government bodies and agencies, attempting to reform executive pay policies, which can be understood within a few categories: disclosure rules, tax policy, accounting rules, and a multitude of other direct regulations.<sup>23</sup> The following very briefly describes some of the notable policies in each category, but for much more detail about the policy history of CEO pay, see Appendix 2.

### **Disclosure**

Around the time of the New Deal, most of the regulatory response centered around disclosure, which was already happening within the context of the country's new found interest in corporate reform. In 1935, the newly developed SEC instituted form 10-K, which required that public companies disclose the compensation of the top three executives making more than \$20,000. Soon after, in 1938, the SEC called for shareholder proxy statements to report compensation of its top three executives. Since the New Deal, the SEC has instituted handfuls of disclosure rules, including a 2009 rule requiring some companies to disclose what they pay for compensation consulting, and has recently proposed a strong disclosure rule – mandated by the Wall Street Reform and Consumer Protection Act of 2010, better known as the Dodd-Frank bill – on the CEO-Worker pay gap.

There is a line of argument that regulator's trust in disclosure rules for CEO pay is misguided, that transparency of pay numbers actually fuels its rise because it tells executives how much their counterparts are making, spurring them to keep up with higher-paid CEOs. According to James Surowiecki at the *New Yorker*, "Sunlight is supposed to be the best disinfectant. But there's something naïve about the new S.E.C. [CEO-Worker pay] rule, which presumes that full disclosure will embarrass companies enough to restrain executive pay."<sup>24</sup>

The main counters to this line of argument are as follows. CEO to worker pay disclosure is not at all necessary for the "peer benchmarking" to which Surowiecki is referring. Yet transparency is necessary for instituting any other regulatory measures and less transparency is certainly not going to lower CEO pay. The important point about the pay ratio information in particular is it will only be effective if workers, shareholders, and others put it to good use and force companies to justify their outrageous pay at the very top. When it comes to curbing CEO pay, there are many important steps to take once disclosure rules are put in place.

### **Tax Policy**

The tax code is another way Congress has tried to shape both the amounts and the structure of executive pay, for example through changes in marginal tax rates, defining how compensation schemes like stock options should be taxed, and through tax loopholes, namely the performance pay loophole created when the Clinton Administration attempted to limit CEO pay.

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<sup>22</sup> As we described earlier, the period between World War II and the mid-1970s is often called the Great Prosperity or the Great Compression, characterized by robust economic growth with strong public investment and labor's share of income relative increased while the share of higher incomes declined and diminished inequality.

<sup>23</sup> These categories come from Murphy, Kevin. 2012. "The Politics of Pay: a Legislative History of Executive Compensation." in *Research Handbook on Executive Pay*, edited by Randall S. Thomas and Jennifer G. Hill. Northampton, MA: Edward Elgar.

<sup>24</sup> Surowiecki, James. 2013. "Open Season." *New Yorker*, October 21. Retrieved July 29, 2014 (<http://www.newyorker.com/magazine/2013/10/21/open-season-3>).

Thomas Piketty and Emmanuel Saez have been most vocal about the ways in which marginal income tax rates impact executive pay, arguing that high marginal income tax rates were a key factor in constraining executive pay and that the much lower rates from 1980 onward did the reverse. This argument is contested by some CEO pay scholars, a discussion which is beyond the scope of this primer. The point we are making here is simply that marginal tax rates are considered by many economists and policymakers to be a useful tool to fix executive pay.

According to economist Kevin J. Murphy, in the 1920s both the income tax and the stock option were new “and no one had figured out how options would be taxed.”<sup>25</sup> The choices were a) as ordinary income when options are exercised or b) at the lower capital gains rate when the exercised options are sold. In 1946, the Supreme Court ruled for the former, that the gain from selling options is compensation and, thus, taxable as ordinary income. Congress responded with the Revenue Act of 1950 by creating “restricted stock options” that were taxable – at the capital gains rate – only when the shares were sold. While a handful of companies paid executives in stock options as early as the 1930s, this new section to the tax code led to a noticeable increase in stock options and their favorable treatment became extremely controversial through the 1950s and 60s. Congress responded with The Revenue Act of 1964, which made several specific changes – including a longer holding requirement – to reduce the attractiveness of restricted stock options.

One of the most notorious tax policies is a loophole instituted by former President Clinton. In his 1992 campaign, one of Clinton's key issues was the expanding paychecks of corporate executives. His big idea? Cap deductions for executive pay at \$1 million, which, in 1993, became part of the U.S. tax code as Section 162(m). There were, however, a few exceptions made at the last minute to this rule, most notably one for executive pay that qualified as “performance-based.” The theory behind performance pay – agency theory – is that to better align the incentives of managers and shareholders, executive pay must be linked directly to share performance. According to the I.R.S., salaries, bonuses, stock grants, and perks – travel in private jets and club memberships – are subject to the \$1 million deductibility cap while non-equity incentive plans, stock options, and pensions are fully deductible.<sup>26, 27</sup>

The fact that 162(m) inflated CEO pay is widely accepted amongst CEO researchers. For example, Frydman and Jenter present their data from 1936 to 2005 illustrating total compensation as well as three components of CEO pay: salaries and current bonuses, payouts from long-term incentive plans, and the grant-date values of stock option grants.<sup>28</sup> Their chart (Chart 3, on the following page) shows a rise in stock options as early as the 1950s (when stock options became taxable at the much lower capital gains rate rather than at the rate of earned income).<sup>29</sup>

The frequency of stock option grants gained ground in the 1980s and then surged in the 1990s and 2000s, mainly due to the exceptions in Section 162(m). Despite the intentions of the tax rule, this particular tax reform did not rein in executive pay, but essentially served as a steroidal injection into CEO pay packages.

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<sup>25</sup> Murphy (2012): 10.

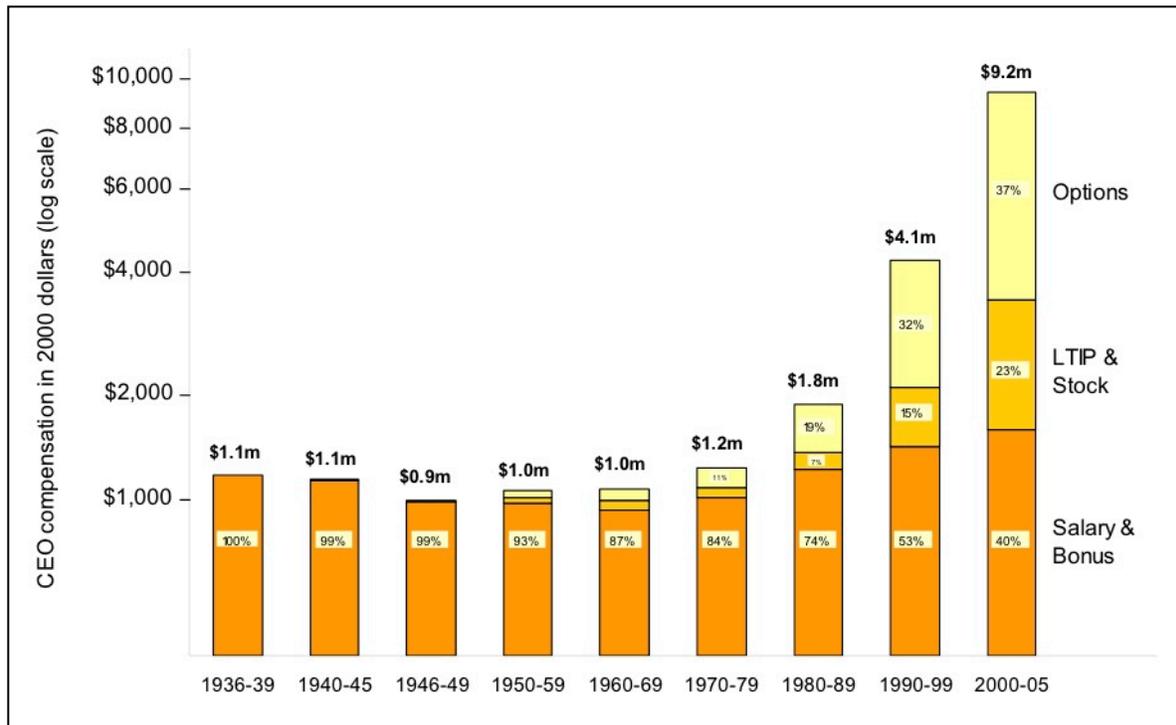
<sup>26</sup> For an expansion on this topic, see Holmberg, Susan R. and Lydia Austin. 2013. “Fixing a Hole: How the Tax Code for Executive Pay Distorts Economic Incentives and Burdens Taxpayers.” Roosevelt Institute White Paper. Roosevelt Institute, New York. Retrieved July 29, 2014 ([http://rooseveltinstitute.org/sites/all/files/Holmberg\\_Austin\\_Fixing\\_a\\_Hole.pdf](http://rooseveltinstitute.org/sites/all/files/Holmberg_Austin_Fixing_a_Hole.pdf)).

<sup>27</sup> These are *most likely* fully deductible. According to Balsam (2012), while these features of executive compensation are eligible for deduction, because the IRS has specific requirements about performance pay, sometimes companies choose not to comply and thus willingly lose the full deduction.

<sup>28</sup> Frydman, Carola and Dirk Jenter. 2010. “CEO Compensation.” *Annual Review of Financial Economics*. 2(1): 75-102.

<sup>29</sup> See also Perry, Tod and Marc Zenner. 2001. “Pay for Performance? Government Regulations and the Structure of Compensation Contracts.” *Journal of Financial Economics* 62:453-488 and Hall, Brian J. and Jeffrey B. Liebman. 2000. “The Taxation of Executive Compensation.” NBER Working Paper No. 7596. MIT Press, Cambridge, MA.

Chart 3: The Structure of CEO Compensation from 1936 to 2005



Source: Frydman and Jenter (2014)

### Accounting Policies

Accounting rules are also considered to play an important role in affecting use stock options and other equity-based executive compensation. For example, Murphy argues that while changes in the use of restricted stock options in the 1950s was mainly driven by tax policies, the popularity of non-qualified stock options in the 1990s and their decline in use in the 2000s is mainly due to accounting policy. One of the most frequently discussed rule changes in the literature is the SEC's FAS123R. In 2006, the SEC changed their accounting rules to finally require firms to expense their grants of stock options to employees. Because boards of directors had viewed options as very cheap to serve out, the new accounting rules, which changed that calculus, led some companies to move from issuing mostly stock options to mostly restricted stock grants.

### Direct Policies

There are a wide variety of policies that affect executive pay that do not necessarily fall into the above categories - disclosure, tax, or accounting. In the early 1930s, some politicians thought that firms that were receiving federal assistance, mainly air- and ocean-mail carriers, paid their executives too much. According to Wells, their policy solution was to limit executive salaries for companies that were recipients of government aid. For airlines that received mail contracts, for example, Congress capped executives' salaries at \$17,500. Much more recently, the Say on Pay provision in the 2010 Dodd Frank Act - the only proposed executive pay provision of Dodd Frank that has actually been implemented - gives shareholders an advisory vote on proposed executive compensation packages.<sup>30</sup>

<sup>30</sup> For more on Say on Pay, see Holmberg, Susan R. 2013. "Can Say on Pay Curb Executive Compensation?: How Shareholder Rights Limit Excessive Pay." Roosevelt Institute Policy Note. Roosevelt Institute, New York. Retrieved July 29, 2014 ([http://rooseveltinstitute.org/sites/all/files/Holmberg\\_Say\\_on\\_Pay\\_09\\_25\\_13.pdf](http://rooseveltinstitute.org/sites/all/files/Holmberg_Say_on_Pay_09_25_13.pdf)).

This section has tried to capture the essence of 100 years of executive pay history in a few pages. Obviously much material has not been covered, but in an effort to put the rest of our discussion on CEO pay in the proper context, we have touched on some of its most important features: the birth of the corporate CEO and the first forms of performance pay, the pay trends, and the basic properties of a very elaborate infrastructure of CEO pay policy. The following section presents the main theories that try to explain the trends in CEO pay as well as help us understand the logic behind some of these different CEO pay policies.

## THE THEORIES: WHY HAS CEO PAY RISEN SO MUCH?

We can't slow the rise in CEO pay if we do not understand why it has risen so quickly. This section describes the major theories on executive compensation that underlie the debate: marginal productivity, agency, and managerial power theory. Why is accurate theory so important? Isn't it just academic mumbo jumbo? Not at all. Economic theory is an extremely powerful force for how we determine the kinds of policies we implement to solve our societal problems. Therefore, it's extremely important we get the theory right. This section explains each of the three theories and specific policy examples that reflect their respective logic.

### *The Theory of Marginal Productivity*

The theory of marginal productivity simply says that a worker's wage is her individual contribution to the output of the business where she works. That productivity is based on her specific skill set and on the state of supply and demand of her skill set. For example, if this worker is a dentist where there are few dentists (low supply) and a lot of bad teeth (high demand), her salary will be much higher than if there are plentiful dentists (high supply) and healthy teeth and people only need their semi-annual cleanings (low demand).

The application of the Theory of Marginal Productivity on CEO pay is just as straightforward: CEO pay has risen so much, so quickly because that is the value of CEOs productivity. The reasoning goes that executives have complicated jobs managing huge, multinational corporations in an increasingly globalized world. There are very few people with the abilities to oversee these enormous corporations. Therefore, their high level of compensation is simply the result of natural market forces - high demand and low supply - rewarding the level of skill required to do their jobs well with bigger compensation packages.

Among researchers of executive compensation issues, there are not a lot of believers of the Theory of Marginal Productivity, for several reasons.

- According to economic theory, efficient market outcomes can only take place when there is no distortion in markets. Perfectly competitive markets require several very restricted assumptions not found in the real economy, such as perfect information and the absence of any externalities. It is silly to justify CEO pay based on basic market logic that just doesn't ring true.
- The argument that the talent pool of potential CEOs is small is frequently challenged because a) CEO demand is lower than is assumed, i.e. the number of very complex and large companies is relatively small and b) CEO supply is higher than assumed. It is hardly convincing to argue that firms could not find enough eligible candidates for their CEO positions. Labor markets are globalized and competitive. It is quite reasonable to expect that there are a number of people with CEO qualifications - advanced degrees in management or specialized fields, such as engineering, and years of successful managerial experience - in the combined US and world labor markets.
- Piketty argues that when we look at the skill level of the top 1 percent income group and compare it to the top 9 percent, the theory of marginal productivity tells us there should be a distinct difference in skill levels between these two groups. However, there is no discontinuity between them in terms of any of the criterion they use: years educated, status of educational institution, or professional experience.<sup>31</sup>

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<sup>31</sup> Piketty, Thomas. 2014. *Capital in the Twenty-First Century*. Cambridge, MA: The Belknap Press of Harvard University Press.

- It is impossible to measure the performance of a CEO in terms of his or her marginal contribution to a firm. Apart from very specific cases, a firm's performance cannot be mostly attributed to one or a couple of top executives. Rather, it is the product of a team, including workers from all ranks, whose contributions can rarely be separated from each other. In a world in which wages do not, by any stretch, keep up with a rise in labor productivity, it is implausible to explain very high compensation packages by the efficient market hypothesis.
- A quick comparison of CEO pay levels between 1992 and 2010 and a company's stock prices over the same period suggests that when the prices of most stocks are high, executives are compensated generously.<sup>32</sup> Because of this correlation, many have begun to suggest the "Pay for Luck" argument, that a firm's share price performance is largely grounded in macroeconomic luck and that compensating a CEO with bonuses and equity grants based on a firm's positive performance amounts, for the majority of cases, to paying for luck; it would be more surprising if a firm did poorly in such conditions.
- There are plenty of CEOs who, by any measure, are not performing for their pay but continue to receive colossal raises. Many companies raised their CEO's pay while their companies were losing money and laying off workers, sometimes while their executives were committing crimes. The Institute for Policy Studies conducted an analysis of 241 CEOs ranked among the 25 highest-paid CEOs in one or more of the past 20 years, from 1993 through 2012. Thirty-eight percent of CEOs in the 500 slots (25 CEOs x 20 years) performed poorly by most people's standards. In other words, over one-third were fired, had to pay massive settlements or fines related to fraud charges, or led firms that crashed or had to be bailed out during the 2008 financial crisis.<sup>33</sup>

What kinds of policies come out of the theory of marginal productivity? That's pretty simple. None. Or rather, the only policy suggestions are to broadly deregulate CEO pay practices. As we mentioned, the majority of economists who work on this issue don't hold this position, but it is circulated in the press ad nauseam as justification for high CEO pay and it does feed back into debates about workers' decreased income share.

### **Agency Theory**

In May of 1990, economists Michael C. Jensen and Kevin J. Murphy published a very influential piece in the *Harvard Business Review* that argued that executive pay was, in fact, not matching performance.<sup>34</sup> As we described above, a lot of executives were getting raises while their companies were failing or CEOs were committing crimes. But according to Jensen and Murphy, the amount of executive pay was not inherently a problem to successful corporate governance. The real issue, they maintained, was the ways in which executive compensation was structured.

The relentless focus on how much CEOs are paid diverts public attention from the real problem - how CEOs are paid. In most publicly held companies, the compensation of top executives is virtually independent of performance. On average, corporate America pays its most important leaders like bureaucrats. Is it any wonder then that so many CEOs act like bureaucrats rather than the value-maximizing entrepreneurs companies need to enhance their standing in world markets?

In making their argument, Jensen and Murphy were employing agency theory, an economic framework that Jensen (along with William H. Meckling) introduced to the field of economics in 1976. In essence, agency theory describes conflicts of interest between corporate managers - the agents - and shareholders - called "principals" -

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<sup>32</sup> Yahoo! Finance. 2014. "S&P 500 Index Chart." Retrieved July 29, 2014 (<http://finance.yahoo.com/echarts?s=%5EGSPC+Interactive#symbol=%5EGSPC;range=1d>).

<sup>33</sup> Klinger, Scott, Sam Pizzigati, and Sarah Anderson. 2013. *Executive Excess 2013: Bailed Out, Booted, Busted*. Washington, DC: Institute for Policy Studies. August 28<sup>th</sup>, 2013. Retrieved July 29, 2014 (<http://www.ips-dc.org/executive-excess-2013/>).

<sup>34</sup> Jensen, Michael C. and Kevin J. Murphy. 1990. "CEO Pay Incentives: It's Not How Much You Pay But How." *Harvard Business Review* 3:1-35. Retrieved July 29, 2014 (<http://hbr.org/1990/05/ceo-incentives-its-not-how-much-you-pay-but-how/ar/1>).

based on the fact that the two groups have a) very different motivations and b) very different knowledge. The motivation of shareholders is to maximize the price of the shares they hold in company stock; the inherent motivation of CEOs is his own financial self-interest. And CEOs hold more information about the operations of the company they manage and their own decision-making than shareholders do.

So what do Jensen and Meckling suggest? Get CEOs and shareholders on the same page by paying CEOs the same way shareholders are paid, via performance pay, particularly equity-based pay like stock options and stock grants. This should sound familiar as Jensen and Meckling's argument was the influential logic of the performance pay loophole in Section 162(m) of the tax code, which, as we've discussed, fueled rising CEO pay.

### ***Managerial Power Theory***

Another line of theory and research, spearheaded by Lucien Bebchuk and Jesse Fried in their 2004 book *Pay Without Performance*, argues that skyrocketing executive pay is a direct result of CEOs' power over decisions within U.S. firms, including compensation itself.<sup>35</sup> This line of reasoning, known as the managerial power theory, or rent extracting theory, looks at the process for determining CEO packages and argues that CEOs can extract a huge economic rent<sup>36</sup> from firms due to their influence on the process for determining their own pay.

Bebchuk and Fried make this argument in contrast to what they call the "Official View" of how the CEO Pay process works, which is the following. In principle, compensation packages for CEOs are determined by independent board of directors or, for larger firms, compensation committees made up of members of the board. In addition, boards and compensation committees typically use compensation consultants, who then are supposed to make pay recommendations based on relevant market information. Central to the "Official View" is the assumption that the board members and compensation consultants are independent actors. Herein, Bebchuk and Fried argue, lies the problem.

Being on a corporate board is a great gig. It offers personal and professional connections, prestige, company perks, and of course money. In 2012, average board member pay was over \$168,000.<sup>37</sup> It only stands to reason that board members want to hold on to these cushy positions. According to Bebchuk and Fried, the key to this is getting your name on the company slate, as once someone is nominated they are basically assured a win because challenges to a board's slate are almost nonexistent. Further, CEOs often have a lot of influence over the nominating process and sometimes exert their power to block nominations. Beyond elections, CEOs can use their control over the company's resources to, well, legally (and sometimes illegally) bribe board members. In fact, there is strong evidence that companies with higher CEO pay compensate their board members more generously, an indication that board members are engaged in a corporate liaison with CEOs rather than serving as independent parties that can assess the appropriate award for the CEO's performance.

Compensation consultants have similar conflicts of interest. Their job is to provide directors with information and advice on executive pay packages. But they have financial incentives to not upset CEOs. Consultants are usually hired through a company's human resources department and CEOs are often closely involved in the process. According to Bebchuk and Fried, "Even if the CEO has not been involved, the chosen consultant has understood that a recommendation that displeases the CEO may preempt the consultant's future employment."<sup>38</sup> These

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<sup>35</sup> Bebchuk, Lucian and Jesse Fried. 2005. *Pay Without Performance: The Unfulfilled Promise of Executive Compensation*. Cambridge, MA: Harvard University Press.

<sup>36</sup> We're seeing the concept rent-seeking used more and more in the media. It simply means leveraging one's wealth to capture more wealth without creating any real economic value.

<sup>37</sup> Xavier, Jon. 2013. "Board of Directors Compensation on the Rise, but Less of it is Cash." *Silicon Valley Business Journal*, September 12. Retrieved July 29, 2014 (<http://www.bizjournals.com/sanjose/news/2013/09/12/board-of-directors-compensation-on-the.html>).

<sup>38</sup> Bebchuk and Fried (2005): 38.

consultants work for specialized compensation firms that have to consider the future of their business with the company or with the same CEO if he later lands at another company. Furthermore, these firms often use the compensation of CEOs at similar or larger firms as benchmarks for fair compensation. Often the firms used as benchmarks are clients of the same consulting firms, and as one CEO's pay rises, it raises others' pay up along with it, regardless of company performance, in a ratcheting effect.

Agency theory and managerial power theory agree that there are severe problems with CEO pay practices. The key difference between the two theories, however, is that managerial power theory, unlike agency theory, does not see executive pay design as a ready tool to alleviate "agency problems." As we just described, managerial power theory hinges on the power CEOs hold over the pay process, that CEOs are in just the right position to set their own pay, including the performance pay that agency theorists Jensen and Meckling have recommended for aligning shareholders and executives' interests.

One of the recommendations coming out of managerial power theory is that more independent boards of directors, who are supposed to act on behalf of shareholders, and more involvement of shareholders in the decision-making process in public firms may be a good solution to the ongoing corporate governance problem, including the CEO pay bubble. In fact, the Say on Pay provision of Dodd-Frank could be considered, at least in part, based on the managerial power theory, as it leans (albeit weakly because it's only an advisory vote) toward giving shareholders more power in the CEO pay setting process.

Piketty and Saez are also proponents of the managerial power theory. As we mentioned, Piketty argues in *Capital*<sup>39</sup> (and elsewhere with his colleagues) that high marginal income tax rates were a key factor in constraining executive pay and the much lower rates from 1980 onward did the reverse. Their premise is that when tax rates are high, executives have little incentive to fight for big raises. But lower marginal tax rates provided the incentive for executives to wield their bargaining power to fight much harder for higher pay. "After 1980 [when top marginal tax rates fell dramatically], the game was utterly transformed."<sup>40</sup>

What is important to notice about all three of these theories – marginal productivity, agency, and managerial power – is that they are based on an ideology called shareholder primacy, which we will challenge in the following section.

## WHO ARE THE SHAREHOLDERS?

While all of these theories diverge in the ways we have described above, they all share one common feature: shareholder primacy. Shareholder primacy is exactly what it sounds like. It argues that shareholders of a company's stock are the one and only corporate stakeholder. That means that unlike consumers, workers, communities, and so forth, they are the only group with any skin in the game and a corporation's only goal in deciding what it produces and sells and how it conducts its business should be maximizing its profit for shareholders.

Presented as natural law rather than the opinion of some economists, shareholder primacy has deeply embedded itself in the consciousness of most politicians and journalists and has been reproduced in our

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<sup>39</sup> And elsewhere with Emmanuel Saez.

<sup>40</sup> Piketty (2014): 510.

classrooms, to the extent that today, most of the American public has come to take this myth for granted.<sup>41</sup> However, that is starting to change.

At the 2013 Allied Social Sciences Association annual meeting, where theories like marginal productivity theory are basic tenets of economic thought, a French financial economist named Jean Charles Rochet gave the keynote address, in which he shredded shareholder primacy. In the paper he presented at the conference, Rochet says: “Everyone knows that corporations are not just cash machines for their shareholders, but that they also provide goods and services for their consumers, as well as jobs and incomes for their employees. Everyone, that is, except most economists.”<sup>42</sup>

Cornell Law professor Lynn Stout, in her 2012 book *The Shareholder Value Myth*, has been working hard to disabuse us of this core myth of American capitalism. Stout argues that while most people think that corporations are legally required to prioritize shareholders above all else, it’s only an ideology.

United States corporate law does not, and never has, required directors of public corporations to maximize either share price or shareholder wealth. To the contrary, as long as boards do not use their power to enrich themselves, the law gives them a wide range of discretion to run public corporations with other goals in mind, including growing the firm, creating quality products, protecting employees, and serving the public interest.<sup>43</sup>

Stout also argues that shareholder primacy not only not a legal requirement, but it’s also a horrible idea because it fosters a short-term perspective that values rising stock prices above all else, above workers, above customers, above investments, and above the regulations they are legally obligated to follow.

A huge part of the problem with shareholder primacy is that the theory projects an image of mom and pop investors who put their life savings in the hands of the company they invest in. But the majority of stock ownership is managed by institutional investors – pension, mutual and hedge funds – on behalf of individual investors. In other words, the fact that institutional investors manage most stock holdings results in the short-termism that Stout is talking about. While individual investors are in it for the long haul, institutional investors feel the pressure to attract clients by showing them higher and higher returns. Combine that short-term motivation of institutional investors with the enormous power (because they control so much stock) over a company’s business decisions and we have a corporate culture that, according to Stout, “favors strategies like cutting expenses, using cash reserves to repurchase shares, and selling assets or even the entire company.”<sup>44</sup>

Institutional investors’ power over corporate decisions includes the structure of executive pay packages, pay decisions that are sullied with further conflicts of interest. For example, mutual funds alone own more than 20 percent of all shares in U.S. public companies.<sup>45</sup> They also happen to manage company pension and 401(k) plans and are directly retained by the very executives whose pay packages they are asked to approve. Indeed, a 2011

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<sup>41</sup> The intellectual godfather of shareholder primacy is University of Chicago economist Milton Friedman, who wrote in the *New York Times* 1970 “a corporate executive is an employee of the owners of the business [i.e. the shareholders]. He has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires, which generally will be to make as much money as possible.” Friedman, Milton. 1970. “The Social Responsibility of Business is to Increase Its Profits” *The New York Times Magazine*, September 13. Retrieved July 29, 2014 (<http://www.colorado.edu/studentgroups/libertarians/issues/friedman-soc-resp-business.html>).

<sup>42</sup> Magill, Michael, Martine Quinzii, and Jean-Charles Rochet. 2010. “Reforming Capitalism.” University of Southern California Working Paper, Los Angeles, CA. Retrieved July 29, 2014 (<http://www-bcf.usc.edu/~magill/research/reform-cap.pdf>).

<sup>43</sup> Page 3-4 of Stout, Lynn. 2012. *The Shareholder Value Myth*. San Francisco, CA: Berrett-Koehler Publishers.

<sup>44</sup> Stout (2012): 69.

<sup>45</sup> From the AFL-CIO. 2014. “About the Mutual Fund Votes Survey.” Retrieved July 29, 2014 (<http://www.aflcio.org/Corporate-Watch/Paywatch-2014/Mutual-Funds-and-CEO-Pay/About-the-Mutual-Fund-Votes-Survey>).

AFSCME<sup>46</sup> report revealed that the largest mutual funds – Vanguard, BlackRock, ING, and Lord Abbett – “are the least likely to use proxy votes to align executive pay with performance,” and vastly outweigh the preferences of the smaller funds, which seem to vote against “management-initiated” compensation proposals. During 2012, only 16 percent of mutual fund families voted against Say-on-Pay proposals to constrain executive pay.<sup>47</sup>

The knowledge that shareholder primacy, an American mythology that is at the core of how we think about corporate decision making, is so evidently flawed can free us to think of a range of options – through policy, corporate norms, and culture – for changing CEO pay practices. The irony is that broadening the scope of corporate stakeholders would benefit individual shareholders, who typically hold the more sustainable long-term view of company performance.

## SOLUTIONS TO OUR CEO PAY PROBLEM

There is a vast array of possible solutions to fix CEO pay practices. The Institute for Policy Studies puts forth an extremely useful and comprehensive list in their Executive Pay Reform Scorecard of potential policies.<sup>48</sup> Rather than repeating those ideas here, we want to emphasize an idea that is not getting enough circulation. If we are going to solve our CEO pay problem, we need to move outside of the shareholder primacy framework and devise our solutions for CEO pay within the more comprehensive stakeholder corporate model.

The stakeholder corporation is not a new idea. While the term stakeholder has been in circulation since the 1960s, R. Edward Freeman brought it into the management world with his 1984 book *Strategic Management*, in which he proposed that effective management is balancing the interests of all the corporation’s stakeholders, including employees, customers, and communities.

Simply put, a stakeholder is any group or individual who can affect, or is affected by, the achievement of a corporation’s purpose. Stakeholders include employees, customers, suppliers, stockholders, banks, environmentalists, government, and other groups who can help or hurt the corporation.<sup>49</sup>

It’s not a complicated idea. Balancing the interests of corporate stakeholders simply means thinking beyond the next quarter. It means investing in innovation and investing in its workers and community so that they invest in the company. Costco is an exemplar of stakeholder management: the company operates under an explicit strong code of ethics, pays its workers a living wage, and, by the way, paid its CEO, Craig Jelenik, \$4.83 million in 2012, markedly lower than Walmart CEO’s \$19.3 million. Jelenik says, “As long as you continue to take care of the customer, take care of employees, and keep your expenses in line, good things are going to happen to you.”<sup>50</sup> The company philosophy has rendered them enormous worker and community loyalty and profit margin. Lo and

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<sup>46</sup> AFSCME is the American Federation of State, County, and Municipal Employees, AFL-CIO.

<sup>47</sup> American Federation of State, County, and Municipal Employees, AFL-CIO. 2011. “Vanguard Tops List of Excessive CEO Pay Enablers.” *AFSCME Press Release*, May 17. Retrieved July 29, 2014 (<http://www.afscme.org/news/press-room/press-releases/2011/vanguard-tops-list-of-excessive-ceo-pay-enablers>).

<sup>48</sup> See Klingler, Scott, Sam Pizzigati, and Sarah Anderson. 2013. *Executive Excess 2013: Bailed Out, Booted, Busted*. Washington, DC: Institute for Policy Studies. August 28<sup>th</sup>, 2013. Retrieved July 29, 2014 (<http://www.ips-dc.org/executive-excess-2013/>).

<sup>49</sup> Freeman, Edward. *Stakeholder Management*. 1984. Cambridge, UK: Cambridge University Press.

<sup>50</sup> Stone, Brad. 2013. “CEO Costco Jelinek Leads the Cheapest, Happiest Company in the World.” *Bloomberg Businessweek*, June 6. Retrieved August 5, 2014 ([www.businessweek.com/articles/2013-06-06/costco-ceo-craig-jelinek-leads-the-cheapest-happiest-company-in-the-world#p3](http://www.businessweek.com/articles/2013-06-06/costco-ceo-craig-jelinek-leads-the-cheapest-happiest-company-in-the-world#p3)).

behold, over the past five years, Costco's stock price is up by 62 percent while Wal-Mart's has increased by less than half that amount.<sup>51</sup>

The concept of the stakeholder corporation has slowly begun to take root, particularly since the failed early 2014 Volkswagen UAW vote in Chattanooga brought attention to the viable form of German corporate governance, which is arguably also a stakeholder model.

With the problems of shareholder primacy in mind, we suggest that steps for controlling CEO pay should fall into two categories. The first should involve focusing on reversing failed proposals that were the result of misguided shareholder primacy ideology. The second should advance the vision of the stakeholder corporation.

### ***Undoing Shareholder Primacy***

The most critical priority is to close the performance-pay loophole and stop subsidizing pay practices that encourage CEOs to behave like financial speculators. In 2013, Democratic Senators Richard Blumenthal and Jack Reed, with Rep. Lloyd Doggett of Texas, introduced the Stop Subsidizing Multimillion Dollar Corporate Bonuses Act, which would cap the deductibility of compensation at \$1 million, as Clinton had originally proposed, regardless of the form that compensation takes. The legislation also broadens the range of Section 162(m) by applying it not just to public companies but also to all companies that file quarterly reports with the SEC. It would also no longer be limited to CEOs and the three highest paid executives in a company: it would apply to any employee earning more than \$1 million.

Economist William Lazonick proposes stronger regulation of stock buybacks. The current SEC rule, he argues, "has given top executives license to use buybacks to manipulate the market." Lazonick proposes that the SEC rescind its current rule and "conduct a Special Study, on the scale of its 1963 study of securities markets that resulted in the creation of NASDAQ, of the possible damage that open-market repurchases have done to the U.S. economy over the past three decades."

One small and familiar step, endorsed by many shareholder-primacy advocates as well, would be to move toward more independent boards of directors by reducing the power of the CEO in the nominating committee.

### ***Stakeholder Reforms***

But it's necessary to go well beyond these steps, which don't challenge the assumptions that led to the 1993 reform. Yes, we need to reform corporate boards, but let's do it by following the successful German model and create a place for workers at the board table. Employee board-level representation is a core part of Germany's corporate "dual structure:" a management board for day-to-day functions and a supervisory board for more high-level decisions, akin to U.S. boards. Depending on a company's number of employees, up to one-half of the supervisory board members are employee representatives rather than shareholders.<sup>52</sup>

We also need to more broadly strengthen the ability of workers to claim a fair share of the wealthy they produce, which would drive the economy forward by increasing workers' spending power, provide a check on CEO incomes, and reform corporate missions to include increasing the well-being of workers and the community. The Roosevelt Institute has laid out a host of proposals to both strengthen current labor laws and to transform policy

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<sup>51</sup> Nolan, Hamilton. 2013. "Costco: the Anti-Wal-Mart." *Gawker*, June 6. Retrieved August 5, 2014 ([gawker.com/costco-the-anti-wal-mart-511739135](http://gawker.com/costco-the-anti-wal-mart-511739135)).

<sup>52</sup> Hopt, Klaus J. and Patrick C. Leyens. 2004. "Board Models in Europe. Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France, and Italy." *European Company and Financial Law Review* 1 (2):135-168.

to empower workers given the structure of the twentieth-first century economy.<sup>53</sup> Some of the policies would increase the bargaining power of workers in an economy increasingly dominated by large employers that sit on top of global supply chains. Other policies include ways that workers could be given a role in corporate decisions on a range of issues that impact workers and communities, including the introduction of new products, decisions to move or to invest in new facilities, pricing and marketing.

We also need to redefine performance pay to move beyond the narrow metric of stock price. Companies should pay their executives for performance (only after the fact), with performance measured by what Edward D. Hess of the Darden Business School and author of the 2000 book *Smart Growth* calls “authentic earnings.” Hess identifies “non-authentic earnings” as “numbers manufactured creatively by accountants and investment bankers.” Authentic earnings, based on real transactions with real customers, provide a broader and more accurate picture of a company’s productive capacity, engagement with new markets, and technological innovation than share price.

And let’s, as a society, reward companies and CEOs that not only keep executive pay down but increase the well-being of all those connected to the corporation. One compelling proposal would adjust the corporate tax rate based on the ratio of CEO pay to the average pay for workers in the company. At the moment, this is difficult to implement, or even to study, because the data on average pay is invisible or unreliable. In some cases, it should include employees of firms, often offshore, that contract solely with the parent company, and it might have to be adjusted based on industry sector – for example, a firm like Apple, where the average employee might be an engineer, will look much better than a firm like Costco, even though Costco pays very well for its sector. But the reporting provision of Dodd-Frank, for the CEO to Worker pay ratio, if implemented effectively, could provide the data needed to develop a policy that would push against inequality at both the executive and worker levels.

Beyond policy efforts, we need to change our cultural understanding of what corporations are for. It’s highly ironic that one of the most articulate critiques of shareholder primacy was delivered by one of its most grandiose beneficiaries: Jack Welch of General Electric. After years as one of the best-paid celebrity CEOs, and after taking a retirement package worth \$419 million, including tax-free perks such as club memberships and use of private aircraft, Welch told the *Financial Times* in 2009 that the doctrine of shareholder primacy was “the dumbest idea in the world,” and added: “Shareholder value is a result, not a strategy ... your main constituencies are your employees, your customers, and your products. Managers and investors should not set share price increases as their overarching goal. ... Short-term profits should be allied with an increase in the long-term value of a company.” A few days later, Welch backtracked, but his words make a biting case against the doctrine on which he built his career and reputation.<sup>54</sup>

When even Jack Welch can see that Milton Friedman’s doctrine was no eternal rule, but one economist’s theory with no basis in law, then business schools, economics departments, law schools, and financial journalists should be able to do the same. If they can train students, including future CEOs, how to think creatively about the challenges corporations face in building a viable business that meets its obligations to all its stakeholders, then even if CEOs continue to be well-paid professionals – although not at today’s stratospheric levels – at least they will be paid for helping their companies and communities become better off.

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<sup>53</sup> See Kirsch, Richard. 2014. “The Future of Work in America: Policies to Empower American Workers and Secure Prosperity for All.” Roosevelt Institute Report. Roosevelt Institute, New York. Retrieved August 5, 2014 (<http://rooseveltinstitute.org/sites/all/files/Kirsch.Future%20of%20Work.Policies%20to%20Empower%20American%20Workers.pdf>).

<sup>54</sup> Welch, Jack and Suzy Welch. 2009. “Jack Welch Elaborates: Shareholder Values.” *Bloomberg Businessweek*, March 16. Retrieved July 29, 2014 ([http://www.businessweek.com/bwdaily/dnflash/content/mar2009/db20090316\\_630496.htm](http://www.businessweek.com/bwdaily/dnflash/content/mar2009/db20090316_630496.htm)).

## APPENDIX 1: THE BASICS OF CEO PAY COMPOSITION

Someone just beginning to study the CEO pay issue will notice quickly that the various numbers circulated in the media are often inconsistent. According to the Economic Policy Institute, average CEO pay for 2013 was \$15.2 million,<sup>55</sup> while the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO) reported \$11.7 million as the average.<sup>56</sup> Tracking these numbers can quickly get confusing. The reason for these discrepancies is that researchers use different methodologies to capture the myriad combinations of equity-heavy based pay that executives receive. In particular, there is some disagreement as to whether “stock options” or “stock options exercised” better estimates the value of executive stock options.

To help abate some of the confusion concerning calculating CEO pay, the following describes the types of compensation used in eight widely circulated reports – based on an Economic Policy Institute table.<sup>57</sup>

Chart 4: Comparison of CEO pay definitions

	Salary	Bonus	Stock option grants	Stock options exercised	Restricted stock grants	Long-term performance-based grants	Other compensation	Definition of companies
<i>EPI options realized definition</i>	X	X		X	X	X		CEOs at top 350 companies by sales
<i>EPI options granted definition</i>	X	X	X		X	X		CEOs at top 350 companies by sales
<i>WSJ series realized direct compensation definition</i>	X	X		X	X	X		CEOs at a varying number of companies
<i>WSJ series total direct compensation</i>	X	X	X		X	X		CEOs at a varying number of companies
<i>Frydman and Jenter</i>	X	X	X		X	X	X	CEOs at S&P 500 firms
<i>Bebchuk and Grinstein</i>	X	X	X		X	X	X	CEOs at S&P 500 firms
<i>Lazonick</i>	X	X		X	X	X	X	Top 100 executives
<i>New York Times</i>	X	X	X		X		X	Top 100 executives

**Source:** Compustat, Wall Street Journal, Frydman and Jenter (2010), Bebchuk and Grinstein (2005), Lazonick (2011), New York Times (Singer 2012)

<sup>55</sup> Mishel and Davis (2014).

<sup>56</sup> AFL-CIO. 2014. “Executive Paywatch: High-Paid CEOs and the Low-Wage Economy.” Retrieved May 28, 2014 (<http://www.aflcio.org/Corporate-Watch/CEO-Pay-and-You/>).

<sup>57</sup> Mishel, Lawrence and Natalie Sabadish. 2013. “Methodology for Measuring CEO Compensation and the Ratio of CEO-to-Worker Compensation, 2012 Data Update.” EPI Working Paper #298. Economic Policy Institute, Washington, DC. Retrieved July 29, 2014 (<http://www.epi.org/files/2013/wp298-ceo-to-worker-pay-methodology.pdf>).

<sup>58</sup> Lazonick (2014): Table 1.

### ***Types of Executive Compensation***

***Salary:*** Just like the average worker, CEOs get paid periodically according to their contracts. However, a CEO's salary only accounts for between three and seven percent of her total compensation.<sup>58</sup>

***Bonuses:*** First implemented as an attempt to align the incentives of a company's top boss with that of the company as a whole, bonuses are usually a percentage of the yearly profits of a firm.

***Stock Options:*** A stock option is the right to buy or sell a certain stock at a certain price before a certain date. Employee stock options are limited to "call options," which are the right to buy the stock from the issuer of the option, in this case the company itself. For employees granted stock options, the option must vest before it can be exercised, but the expiration date is usually close to ten years after the grant date. The goal for someone holding an option is to exercise the option when the market price is above the exercise price, followed by a quick re-sell to the market, allowing the original holder of the option to pocket a quick profit. This metric uses the Black-Scholes methodology for calculating the market price of an option, accounting for expiration date, the risk free rate, stock price at the time of the grant, volatility of returns, and the exercise price.

***Stock Options Exercised:*** This measures the profits earned on exercising the stock option grants explained above. The Stock Options Exercised measure is preferred by many economists and is useful because of its ability to highlight the misaligned incentives that top executives face because of their compensation packages; rather than incentivizing long-term, steady growth, a cycle of highs and lows in a company's stock price can be very profitable and even preferable for a top level executive because it helps secure low exercise prices while making room for profits when the stock hits its peaks. In some reports, this metric is referred to as *Stock Options Realized*.

***Restricted Stock Grants:*** Another strategy to align incentives, stock grants are an attempt to recreate the significant equity positions that company managers used to hold in their companies. A common compensation instrument for employees at various levels, restricted stock grants must be held for a certain predefined "vesting" period before they can be treated like other stocks in an employee's portfolio.

***Long-Term Performance Based Grants:*** These types of incentives are meant to encourage long-term alignment of CEO interests and shareholder interests, aimed at minimizing shortsighted efforts to temporarily boost the stock price and to encourage long-term investment in projects that will not see a return within the fiscal year. Long-term performance based grants are generally set with objectives in three main areas: financial metrics, shareholder growth metrics, and performance metrics. Financial metrics include sales, profit, return on assets, and other accounting figures. Shareholder growth goals reward improvement in the stock price and strong Total Shareholder Return. Finally, performance metrics can refer to specific goals within individual business segments or improvement in the relative rank of the company on an index of comparable firms.<sup>59</sup>

***Other Compensation:*** This final category covers the remaining types of "innovative" compensation for executives, otherwise known as perks: private jets and helicopters, golf vacations, hotel suites, and other luxuries are often afforded CEOs and other top executives as tax-deductible company expenses.

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<sup>59</sup> Nemerov, Don. 2012. *Are Performance-Based LTI Plans Effective?* WorldatWork. Scottsdale, AZ: Grant Thornton LLP. Retrieved July 29, 2014 ([http://www.granthornton.com/staticfiles/GTCom/Grant%20Thornton%20Thinking/Surveys/Performance\\_Based\\_LTI\\_Plans\\_Reprint.pdf](http://www.granthornton.com/staticfiles/GTCom/Grant%20Thornton%20Thinking/Surveys/Performance_Based_LTI_Plans_Reprint.pdf)).

## APPENDIX 2: A TIMELINE OF CEO PAY POLICIES<sup>60</sup>

Date	Governmental Body/Agency	Type of Policy	Name	Description
1932-1933	United States Senate Committee on Banking and Currency	Disclosure	The Pecora Commission	The Pecora Commission investigated the causes of the 1929 financial crisis, exposing preferential treatment of bank executives as well as fraudulent tax evasion strategies and ultimately leading to the resignation of National City Bank's (now Citibank) president, Charles Mitchell. The investigation set an important precedent in the area of corporate disclosure of executive treatment, demonstrating an unwillingness of the US government to allow opaque and undue benefits to corporate executives at the expense of other actors inside and outside the firm, and leading to both the Glass-Steagall Act and the 1933 Securities Act.
1932	Interstate Commerce Commission	Disclosure	N/A	In the wake of a proposed bailout for underperforming banks and rail companies, the Interstate Commerce Commission required all railroads to disclose the pay of executives earning over \$10,000 per year. Outrage from the newly elected Roosevelt administration at the levels of pay disclosed after the ruling prompted the Federal Coordinator of Transportation to informally impose a \$60,000 per year cap on pay for railroad presidents. Though the cap was non-binding, the decision was met with uniform compliance.

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<sup>60</sup> This timeline is based on Murphy (2012), Wells (2012), and Pizzigati, Sam. 2012. *The Rich Don't Always Win: The Forgotten Triumph over Plutocracy that Created the American Middle Class, 1900-1970*. New York: Seven Stories Press.

Date	Governmental Body/Agency	Type of Policy	Name	Description
1933	United States Congress	Disclosure	Securities Act of 1933	Responding broadly to the financial crisis that began in 1929 with the infamous stock market crash that initiated the Great Depression, the Securities Act of 1933, also known as the Truth in Securities Act, set the pace for corporate disclosure across all areas of corporate activity, mainly dealing with stock issuance. Included were provisions mandating disclosure of executive pay, defining pay as salaries and bonuses, for all corporations with over \$1 million in assets. The act also determined that all insider profits generated by company-granted options exercised and resold within six months has to be returned to the company, a ruling that would reign in total compensation for almost 60 years. Most “over-the-counter” firms (companies that did not trade their stock on exchanges) were exempt from these provisions.
1933	United States Congress	Direct	N/A	Following the Pecora Commission’s discovery of pervasive cronyism in the taxpayer-subsidized awards of air-mail contracts, mainly to friends of former President Hoover, Senator Hugo Black (D-Alabama), embarked on a campaign to provide greater oversight to the industry; the development of fledgling industries such as air and ocean mail required government money that had formerly been squandered on bloated pay checks. His 1933 amendment enacted by Congress denied federal ocean and air-mail contracts to companies that paid their executives in excess of \$17,500.
1933	United States Senate	Direct	The Insurance Company Act	In 1933, the Senate voted to impose a \$17,500 limit on executive pay for any corporation in line to receive a new or extended Reconstruction Finance Corporation (RFC) loan. The final legislation enacted into law only limited RFC loans to firms that have set executive pay at levels the RFC deemed “reasonable.”

Date	Governmental Body/Agency	Type of Policy	Name	Description
1934	United States Congress	Disclosure	Securities Exchange Act of 1934	The Securities Exchange Act echoed the administrative regime's calls for transparency in financial markets, creating broad regulations for trading of equity in the secondary market and placing such activity under the purview of the Securities Exchange Commission, which was created simultaneously. The purpose of the SEC's introduction of the Form 10-K was to align a company's financial performance and its equity's standing in secondary markets. It also required exchange-traded public corporations to disclose compensation for the top three officers earning more than \$20,000 per year in salaries and bonuses.
1934	United States Congress	Disclosure	Revenue Act of 1934	Administrative interest in compensation policy of public corporations was not limited to executives; the Revenue Act of 1934, which raised some of the higher bracket income tax levels for individuals and levied a 13.75% corporate tax, also included a section requiring corporations list - by name and by dollar-value - compensation those employees and officers making more than \$15,000 per year, or \$266,305.97 in 2014 dollars. It is important to note that, even under the new more progressive tax plan, employees at this pay-grade were paying only 13% at the combined rate.
1938	Securities Exchange Commission	Disclosure	Securities Exchange Act Release No. 1823	In a release redolent of the '34 Act that created the SEC, the commission determined that shareholder proxy statements - the documents containing the information required by law to be delivered regularly to shareholders - must contain the compensation afforded to the company's top three earners.
1942	Securities Exchange Commission	Disclosure	Release No. 34-3347	The 1938 release was updated in 1942 to require that the proxy statements report information on executive compensation for companies' top three earners in tabular form, rather than just a narrative. The decision aimed at making the information easier to locate in proxy statements, facilitating comparison of executive compensation with other firms, and reducing the obfuscation of the facts through accounting jargon that was impenetrable to the average shareholder.

Date	Governmental Body/Agency	Type of Policy	Name	Description
1942	President of the United States	Direct	Executive Order No. 9250	On October 3, a Presidential proclamation created a new federal Office of Economic Stabilization. The proclamation directed this new agency to issue regulations that would limit corporate executive salaries after taxes to \$25,000 per year. FDR's new marching orders also instructed the Treasury Department to deny corporations tax deductions for any salaries over \$25,000 and the Office of Price Administration to not consider salary over \$25,000 a legitimate business expense that corporations could claim as a reason to raise prices. The order also prevented corporations from claiming salaries over \$25,000 for reimbursement under cost-plus government contracts.
1942	Office of Economic Stabilization	Direct	N/A	In late October, Economic Stabilization Office director James Byrnes issued regulations to implement FDR's directive. Byrnes put the gross, before-tax corporate executive salary limit at \$67,200, a figure that would leave top executives with no more than \$25,000 after paying their taxes, life insurance premiums, and other fixed obligations. Byrnes also established a maximum fine of \$1,000 and up to a year in jail for any cap rule violation and denied corporations tax deductions on the entire salary paid out to cap rule violators, not just the amount in excess of \$25,000.
1943	United States Congress	Direct	Public Debt Bill	In March, Congress attached to pending debt ceiling legislation an amendment that revoked FDR's \$25,000 pay cap order and prevented the President from doing anything that might lower executive salaries below their levels between January and September 15, 1942. FDR, without enough votes to sustain a veto, let the legislation become law without signing it.
1945	The Supreme Court of the United States	Tax Changes	Commissioner v. Smith, 324 U.S. 177	The Supreme Court ruled that a gain in the value of a stock option upon exercise of the option is compensation, and taxable as ordinary income, complementing a 1923 decision made by the Treasury holding the same implication. Following a long series of legal battles fought by corporations defending the utility of stock options as incentive plans, the decision left employees earning stock option compensation at a tax-disadvantage.

Date	Governmental Body/Agency	Type of Policy	Name	Description
1950	United States Congress	Tax Changes	Revenue Act of 1950	Pursuant to the Commissioner v. Smith ruling, this act created Section 130A of the tax code, establishing restricted stock options as a means of accessing the tax benefits closed to stock options by the Smith decision. If certain requirements are complied with, no tax is levied until the sale of the stock, at which time lower capital gains rates apply.
1952	Securities Exchange Commission	Disclosure	Release No. 34-4775	A further update to the SEC Release No. 1823 on executive pay disclosure broadened the definition of executive compensation to include pensions and deferred compensation for reporting purposes. The decision was largely a reaction to a shift toward alternate forms of high-value compensation that could be omitted from the 10-K form and left undisclosed. Of course, the statement left open several other disclosure loopholes, equity-based compensation that would come to dominate the makeup of executive compensation in later years.
1954	United States Congress	Direct	Revenue Act of 1954	In 1954, Congress consented to a policy change to restricted stock options, sanctioning re-pricing of the options should the market price of a stock fall below the option's exercise price. Though options-based compensation was engineered as a way to align the incentives of executives with the financial health of the company, this act essentially eliminated the risk element of the option. Should the executive team fail to deliver results, they can still reap profits off of their options by resetting the exercise price below the slumped market price. The act also limited the exercise window to 10 years from the grant date.
1964	Securities Exchange Commission	Disclosure	1964 Securities Act Amendments	Whereas the previous two updates to the SEC release requiring disclosure of executive compensation pertained to the definition of executive pay for reporting purposes, this update sought to broaden the base of companies under its purview by requiring public firms whose stock is traded over-the-counter rather than on an exchange to adhere to the previous disclosure requirements.

Date	Governmental Body/Agency	Type of Policy	Name	Description
1964	United States Congress	Direct, Tax Changes	Revenue Act of 1964	This act made several specific changes - including a longer holding requirement - which reduced the attractiveness and use of qualified or restricted stock options. The act also reduced marginal rates on income, which in turn increased the attractiveness of cash compensation relative to restricted options.
1969	United States Congress	Tax Changes	Tax Reform Act of 1969	This act further reduced top marginal income rates, in addition to reducing corporate tax rates. Non-qualified stock options became tax advantageous for executives and corporations in the highest tax brackets. Reductions in tax rates led to the virtual elimination of qualified stock options in compensation packages.
1972	Accounting Principles Board	Accounting	Opinion No. 25 of the Accounting Principles Board	The Accounting Principles Board's Opinion No. 25 underpinned the dominance of stock option compensation by defining the expense associated with the option that the company must realize as the difference between the market price of the stock at the grant date and the exercise price of the option. Because options awarded as compensation traditionally had exercise prices equal to or greater than the market price at the grant date, stock option awards had essentially zero accounting value as a result of the decision.
1976	Securities Exchange Commission	Direct	Adoption of Amendments to Rules 16b-3 and 16a-6(c)	This 1976 SEC decision solidified the dominance of stock appreciation rights as the preferred tool for incentive compensation when the commission ruled that stock appreciation rights (SARs) are not subject to the six-month short swing profit prohibition outlined in the 1933 Securities Act. Immediately after the decision and until an equivalent decision on restricted stock-options in 1991, companies overwhelmingly shifted their compensation plans toward SARs.
1976	United States Congress	Direct	Revenue Act of 1976	Whereas the SEC's amendments in 1976 made qualified stock options less attractive than SARs as incentive plans, the Revenue Act of the same year explicitly banned new grants of qualified options, though existing plans were still allowed to be exercised within their five year term.

Date	Governmental Body/Agency	Type of Policy	Name	Description
1978	Securities Exchange Commission	Disclosure	Release No. 33-6003 ("The 1978 Release")	The final act in the SEC's quest to ensure transparency and accuracy in corporate reporting of executive pay content and levels, the 1978 reform required that a column be added to the existing tables to show the dollar-value of compensation in the form of perquisites and insurance payments. Perquisites – or perks – are generally non-monetary benefits afforded CEOs and other high-level executives, including company cars, club memberships, legal and financial services, employment contracts, and assets unavailable to lower-level employees. In addition, the SEC expanded the number of named executive officers whose compensation must be reported from three to five.
1981	United States Congress	Direct	The Economic Recovery Tax Act of 1981	Just before the expiration of the last qualified stock options, Congress resurrected the qualified stock options in the form of Incentive Stock Options (ISOs), which fall under many of the same restrictions as qualified options in addition to being limited to \$100,000 per executive per year. ISOs have seen popularity among middle managers and non-profits but, since 1972, the vast majority of stock options granted to executive level employees have remained non-qualified.
1983	Securities Exchange Commission	Disclosure	Release No. 33-6486 ("The 1983 Release")	Echoing the change in ideological regimes that came with Reagan's election, the SEC about-faced on its quest for transparency in corporate governance and disclosure of executive pay, requiring only that the summary compensation table report cash compensation, with no requirements for contingent compensation, interest on deferred compensation, or dividends paid on restricted stock, despite the taxability of these amounts. A highly symbolic and impactful victory for classical liberalism, the decision turned back the dial on corporate accountability to shareholders by decades, despite the fact that the original regulations were intended to streamline corporate activities through transparency rather than restrict them.

Date	Governmental Body/Agency	Type of Policy	Name	Description
1984	United States Congress	Tax Changes	Deficit Reduction Act	This act added Sections 280(G) and 4999 to the tax code in order to attempt to discourage the use of golden parachutes, agreements between a corporation and executive regarding benefits and severance packages upon a change in management. In order to discourage excessive severance pay, Congress enacted a 20% excise tax on any package deemed excessive, defining the term as any package totaling more than three times annual pay over the previous five years. The unintended consequence was that companies began to treat severance packages valued at anything below this limit as reasonable with an endorsement from Congress.
1991	Securities Exchange Commission	Direct	SEC Reinterpretation of Section 16(b) of SEA	In another shift in the consensus on the ideal strategy for aligning executive incentives through compensation, the SEC said that the six-month holding period of qualified stock options begins when options are granted, not when executives acquire shares upon exercise. This decision dismantled the benefit of SARs over stock options, leading to the disappearance of SARs. Though the use of stock options as compensation had already risen considerably in the previous decade, some researchers see this decision as a tipping point for the practice. Today stock options constitute well over half of total compensation packages in many cases.
1992	Securities Exchange Commission	Direct	Reinterpretation of Rule 14a-8(c)(7)	Influenced by the idea that regulation was the weapon of choice for combating market failure and amid public outcry over the level of executive pay embodied by President Clinton’s promise to address the issue, the SEC allowed non-binding shareholder resolutions on executive compensation to be included in proxy statements for the first time, stating that such decisions pertained to “the conduct of the ordinary business operations.” Since the decision, shareholder resolutions addressing executive compensation have consistently outnumbered any other single type of resolution. Though only a handful of proposals passed shareholder approval, likely due to large voting blocks being controlled by parties who were – much like many executives – interested in short-swings in equity prices, even fewer saw implementation.

Date	Governmental Body/Agency	Type of Policy	Name	Description
1992	Securities Exchange Commission	Disclosure	Release Nos. 33-6962, 34-31327 ("The 1992 Release")	The SEC introduces new pay disclosure rules. These require tables summarizing the major components of compensation received by the CEO and the other 4 most highly paid executives, and describing option grants, holdings, and exercises in detail and retrospective to three years. In addition, the dollar value of the options granted was to be reported using either Black-Scholes, or an estimate of the potential value assuming either 5 or 10% annual appreciation.
1993	United States Congress	Tax Changes	The Omnibus Budget Reconciliation Act	Congress approves Section 162(m) of the tax code, which defines and limits executive compensation. This section applies only to public firms and compensation paid to the CEO and the four highest-paid executive officers. Section 162 (m) does not apply to performance-based compensation. Since stock option compensation is generally considered performance-based, this act encouraged the granting of stock options, and led to highly complex compensation agreements.
1997	United States Congress	Tax Changes	Taxpayer Relief Act of 1997	This act, along with the 1998 IRS Restructuring and Reform Act, lowered the maximum tax bracket for capital gains from 28 to 20%. Moreover, any incentive-based (qualified) stock option exercised two years or more after the grant date is treated as a capital gain rather than income, leaving executives in a much better position to profit off of stock-option compensation.
1998	Internal Revenue Service	Tax Changes	Restructuring and Reform Act of 1998	The IRS's version of the 1997 Taxpayer Relief Act offered the consent of the Internal Revenue Service to this preferential treatment of qualified stock options, though non-qualified options still dominate executive pay packages.

Date	Governmental Body/Agency	Type of Policy	Name	Description
2000	Financial Accounting Standards Board	Accounting	FASB Interpretation No. 44	In response to long-standing confusion surrounding APB Opinion No. 25 and following an ineffectual attempt to bring companies to expense their options-based compensation through FASB Statement 123, FASB issued an interpretation of the APB opinion, calling for "variable accounting" of options that are repriced, reloaded, or otherwise modified (such as a change in the number of shares, accelerated vesting, or an extension of the exercise period). Variable accounting would mean that an expense must be recognized each period after the change occurs equal to the increase in the intrinsic value of the options over the original value, minus any such charges made in previous periods.
2002	United States Congress	Accounting, Direct	Sarbanes-Oxley Act	Often called the most far-reaching U.S. Securities legislation to date, the Sarbanes-Oxley Act came in response to the revelation of high-level corporate fraud, most famously involving Enron Corporation and former Big 5 accounting firm Arthur Andersen. Most of the act was designed to prevent conflicts of interests and to broaden disclosure requirements. Among the many and varied provisions were a ban on personal loans to executives and the creation of a one year waiting period for any audit firm employee leaving the company to work as an executive at a client firm. The waiting period also applies to the audit firm, which cannot perform audits for the new employer within one year.
2003	Federal Accounting Standards Board	Accounting	Statement No. 148	This statement replaces the guidelines set out in Statement 123 for transitioning to the more accurate and preferable fair-value reporting standards for stock based compensation. Compared with Statement 123, Statement 148 reduces the burden of transitioning to full reporting of stock based compensation. The result is that companies can fully expense stock based compensation at fair-value - including Black-Scholes valuation for stock option awards. Additionally, Statement 148 requires more frequent and more prominent reporting and requires that, regardless of the reporting method used in the official financial statements, other methodologies must be used to provide accounting information comparable with other firms.

Date	Governmental Body/Agency	Type of Policy	Name	Description
2004	New York Stock Exchange	Direct	NYSE Listed Company Manual Section 303 A 2	In this update to the requirements of NYSE listed corporations, the corporate governance listing standards included a definition of “independent directors” on executive boards, disqualifying any individual receiving over \$100,000 of compensation in excess of their director fees, or whose company receives such payment. Today, the level is capped higher at \$120,000.
2004	United States Congress	Tax Changes	American Jobs Creation Act	Following the Enron scandal, Congress adds Section 409(A) to the tax code in an attempt to limit and restrict withdrawals from nonqualified deferred compensation programs. Directly before Enron filed for bankruptcy protection, executives were able to withdraw from these accounts deferred salaries and bonuses, sparking outrage. Section 409(A) also broadened the definition of deferred compensation: for example, bonuses paid more than two and a half months after the close of the fiscal year were counted as deferred compensation (among other definitions).
2003	Federal Accounting Standards Board	Accounting	Statement No. 148	This Statement replaces the guidelines set out in Statement 123 for transitioning to the more accurate and preferable fair-value reporting standards for stock based compensation. Compared with Statement 123, Statement 148 reduces the burden of transitioning to full reporting of stock based compensation. The result is that companies can fully expense stock based compensation at fair-value – including Black-Scholes valuation for stock option awards. Additionally, the Statement requires more frequent and more prominent reporting and requires that, regardless of the reporting method used in the official financial statements, other methodologies must be used to provide accounting information comparable with other firms.
2006	Securities Exchange Commission	Accounting	FAS123R	One of the most frequently discussed rule changes in the literature is the SEC’s FAS123R. In 2006, the SEC changed their accounting rules to finally require firms to expense their grants of stock options to employees. Because boards of directors had viewed options as very cheap to serve out, the new accounting rules, which changed that calculus, led some companies to move from issuing mostly stock options to mostly restricted stock grants.

Date	Governmental Body/Agency	Type of Policy	Name	Description
2006	Securities Exchange Commission	Disclosure	Regulation S-K Item 407	A recent update to the original Regulation S-K of the Securities Act of 1933 requires that the grant date of options granted as compensation be disclosed and approved by the Board of Directors. Item 407 also requires that the company identify and describe the role of any outside consultants who provide advice on executive compensation policy. Nominally implemented to prevent backdating of options by requiring board approval, the commonly seen alliances between top executives and corporate boards – particularly those with the CEO presiding as Chairman – can leave the policy ineffectual when it comes to correcting for overcompensation of executives.
2006	Securities Exchange Commission	Disclosure, Accounting	SEC Release Nos. 33-8765; 34-55009	This release contains several reporting requirements pertaining to disclosure of executive compensation in accounting materials, including the addition of a Summary Compensation Table, which summarizes compensation for named executives over the preceding three years. The new requirements follow FASB Statement No. 123 ruling in 2004, obliging companies to report the dollar value of all equity based awards, with separate columns for stock and stock options and measured at grant date fair value, as well as the amount of non-equity compensation under incentive plans and all other compensation over \$10,000 not otherwise stated.
2009	Securities Exchange Commission	Disclosure	Amended Item 407(e)(3) of Regulation S-K	In an amendment to the 2006 Item 407 of Regulation S-K, the SEC requires that firms paying in excess of \$120,000 for services from compensation consultants disclose the dollar amount of fees paid for consulting and other related services. The amendment redressed a growing and costly trend among large corporations spending large sums in order to generously compensate top executives; the SEC recognized that, between regular buyback programs and consultation services, executive teams are spending a lot of resources to skirt the object of decades of compensation regulation and to find new, unregulated means of enriching themselves.

Date	Governmental Body/Agency	Type of Policy	Name	Description
2009	United States Treasury Department	Direct	Appointment of the Special Master for TARP Executive Compensation	U.S. Treasury Department appointed Kenneth Feinberg as the Special Master for Compensation for Troubled Asset Relief Program accounts, giving him broad authority to review, approve, reject, and set pay levels without the possibility of appeal by the company. Feinberg, dubbed the “pay czar” by the media, made several decisions regarding executive pay in firms receiving federal aid following the 2008 financial crisis, including instituting salary caps of \$500,000 for firms under his supervision.
2010	United States Congress	Disclosure, Direct	Dodd-Frank Wall Street Reform and Consumer Protection Act	The 2010 bill often shortened to simply “Dodd-Frank” is considered the most comprehensive and significant set of changes to financial regulation to hit the country since the years following the Great Depression and covers numerous areas relevant to executive compensation policies, including a Say-on-Pay mandate; claw-back rules, disclosure on the ratio of CEO pay to the median total compensation of all employees; and so forth

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